



Raising Capital for Real Estate Development Projects using Mezzanine Finance

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Maido Lüiste
Bachelor of Science in Technology

Supervisor: Professor Kauko Viitanen
Instructor: D.Sc. (Tech.) Saija
Toivonen



Aalto University
School of Engineering

Aalto University, P.O. BOX 11000, 00076
AALTO

www.aalto.fi

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Author Maido Lüiste

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Abstract

In financial world, investors are constantly seeking to earn higher return on equity on their invested capital. Mezzanine financing is a possibility to initiate projects using less equity and thus earn higher return for the shareholders. It is also a way to fill the gap between equity and senior loan in capital intensive projects. This research focuses on the use mezzanine finance in real estate sector and on the possibilities to finance real estate development projects in Estonia using mezzanine finance.

The study covers the history and current state of mezzanine finance in Estonia by interviewing top Estonian financial specialists. The results of the study indicate that the history on the use of mezzanine finance in Estonia has been extremely low even though financial advisers have been offering this type of financial advice for years. The analysis on the conducted interviews indicates that mezzanine financing could mostly be received from smaller local banks in Estonia, but apart from that possibility mostly in the form of corporate bond.

The results of this study contribute major part to the little academic evidence that has been recorded on the topic of Estonian financial market to date. It contributes to the understanding why Estonian real estate development companies have not used mezzanine finance as widely as it has been used in other European countries.

Keywords Real Estate Finance, Mezzanine Finance, Real Estate Development

Foreword

This research was initiated out of practical need to define possibilities for Estonian real estate development companies to include mezzanine finance in the development process. During the research process many helpful Estonian financial specialists provided their time to contribute information for this research analysis. Therefore, I would like to thank Veiko Hintsov, Arvo Hallik, Aare Tammemäe, Stanislav Gutkevitšh, Karl-Erik Kodu and Indrek Nuume for their time and energy that helped to analyse the current state of Estonian mezzanine finance supply and demand market. Especially, I would like to thank my instructor Saija Toivonen who contributed many helpful comments and ideas during the process of writing this Thesis.

20.05.15 Tallinn

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Terms and Abbreviations

IRR	The IRR is essentially the interest rate that makes the NPV value of all cash flows equal zero. It represents the return a company would earn if it expanded or invested in itself, rather than elsewhere. (Investopedia, 2014)
LTV	A lending risk assessment ratio that financial institutions and others lenders examine before approving a mortgage. Calculated as: $\text{Loan to Value Ratio} = \text{Loan amount} / \text{Value of the property}$. (Investopedia, 2014)
SPV	Special purpose vehicle. Also referred to as a "bankruptcy-remote entity" whose operations are limited to the acquisition and financing of specific assets. The SPV is usually a subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt. (Investopedia, 2014)

1. Introduction

Introduction part presents the main principles to conduct this study and justifies the research. This section also presents the ground principles for the reader about the sector and the research methods.

1.1 Background and Motivation of the Study

One of the main characteristics of real estate sector and real estate development is that the process of acquiring real property or developing projects is highly capital intensive (Glickman, 2014, p. 12.). Due to this feature, conducting real estate development projects is feasible to only major institutions and well leveraged companies, excluding all other market participants who are lacking sufficient equity. Developers are at the same time rarely carry out their projects fully based on equity financing as equity is expensive source of capital compared to debt. (Montana et al., 2008, p. 81.) Therefore, as much as possible external financing is used widely across the world in real estate sector and especially in real estate development projects.

On the other hand, inclusion of external capital makes the company face a bundle of risks that are inherent with increased return that is achieved by additional gearing. Among them could be the risks of future increase in the interest margins of debts if bank financing is used. Nevertheless, it is clear that external financing is necessary for additional growth for smaller companies and in the situations where lack of equity is the problem. One of the possibilities in this situation for the developer could be to raise additional capital through alternative financing methods such as mezzanine finance to still initiate the project.

The reason why I am writing my Thesis on this topic is that I am employed as a project manager in one of the fastest growing real estate development companies in Estonia and at the moment the company is experiencing the need for additional financing, in addition to bank financing. Partly to decrease the equity share in already initiated projects, so that risk diversification among projects could be enhanced, but in addition that several projects could be conducted at the same time. This, should lead the company to earn higher return on equity if the additional risk aspect is excluded.

Another real life problem for any company is to make a partial exit from long-term development projects which are already financed with senior loan and equity share, but where it is financially reasonable to reduce equity to minimum. By doing this, higher return on equity could be earned from initial project and equity could be spread across different new projects, which the company would like to acquire, but where lack of sufficient equity has been the problem.

Therefore, the starting point for this study was a real life problem of how to deploy additional financing to bank loan in real estate development projects in Estonia, which could minimize equity usage in the development projects, but would also increase the return on equity of the company.

This thesis will firstly focus on the various possibilities used in the real estate sector across the globe for additional financing methods that include using mezzanine finance in development projects. Additionally, an overview of mezzanine financing methods used specifically in the Estonian real estate market to this date will be given, as this is the home market for the company the researcher is employed. To obtain this information the most suitable option in Estonian context are qualitative interviews, as the author acknowledges the lack of academic literature in this field.

The main idea of the study is to provide an overview of the usage of mezzanine and other alternative financing methods in Estonia, as the moment the topic is barely covered at all, nevertheless in academic context.

1.2 Research Problem and Objectives

The purpose of this study is to provide an overview of theoretical mezzanine financing methods in real estate developments, after which a series of qualitative interviews will be conducted with Estonian financing experts, who can provide knowledge of the use of mezzanine and other alternative financing in Estonia for real estate development projects currently ongoing and conducted in the past.

The research question for this study is:

- What possibilities Estonian real estate developers have in practise at the moment to use mezzanine financing in real estate development projects?

Supporting questions that help to answer to the main research question are:

- What are the theoretical mezzanine financing methods? (literature based)
- Which of these financing tools (methods) have been used in Estonia? (empirical part)
- Which of these methods could be used in the current market condition? (empirical part)
- What are the terms to be fulfilled from the viewpoint of the developer to receive additional financing? (empirical part)

1.3 Scope of the study

In general, this study will focus on real estate financing characteristics concerning mezzanine finance, which will be covered using the international experience. In the empirical part, the study focuses on the mezzanine finance used currently and in the past in Estonia. However, even in the international experience and knowledge, the additional financing sector is rather young, therefore, before beginning the study the researcher acknowledges the fact that mezzanine financing area might be uncovered in literature and there are only a few practitioners who could provide relative and useful information among Estonian financial specialists.

Nevertheless, the scope of this research is set on real estate development financing, as real estate sector in general is wide and has different characteristics. For example, core

cash-flow investments require entirely different approach in the sense of financing than development projects.

The research will not go in depths on the topics of real estate and real estate financing in general. Rather it will start on defining specific need for additional financing and identifying the different methods that will qualify under mezzanine finance.

1.4 Research Methodology

The study is divided into two major sections: literature review and empirical study. The literature review is based on all the materials researcher can access that allow to cover the area as widely as possible. Books, articles, academic journals and such are utilized.

Empirical study is based mostly on quantitative interviews with the area's experts in Estonia. Empirical section contributes the major part of the study as most of the knowledge of Estonian mezzanine financing has not been recorded in any sense so far in the literature, which makes this method the one and only source to gather relevant information of high quality. This is the reason of choosing this method for empirical section. Interview questions will be structured and sent to the interviewees beforehand, however unstructured elements will be also included allowing the researcher to ask relevant new questions during the interview process as well. This kind of structure will ensure that all of the participants will answer the same questions, but additional new information will be also gathered, that would have otherwise been excluded.

The researcher acknowledges that conducting research by using qualitative interviews inherently carries some risks that might affect the results of the study. These risks could include incompetent interviewer or an interviewee, however, in this study the objective is to mitigate the incompetent interviewee risk. However, by doing interviews with several specialists in the field that should mitigate the problem.

In addition to contributing to the development of Estonian financing market, the study will also record the current condition of Estonian financial market regarding lending to the real estate sector.

The participants in the interviews were chosen by their field of operations. That is all companies in Estonia that are specialised in financial advisory were contacted. Especially those companies which are specialised on bond emissions and structuring mezzanine deals. All the interviews were conducted in Tallinn, Estonia using Estonian as working language.

1.5 Research structure

The research is divided into four sections: introduction (Chapter 1), literature review (Chapter 2), empirical study (Chapter 3) and findings of the study (Chapter 4). The structure of the research is presented in Figure 1. The introduction will provide information on the background of the study and the research problem, but also on the planned methods to be used during the research. After that, literature review focuses on international knowledge on mezzanine finance in general and lists up positive and

negative aspects of each tool. In the end of that section, a general idea of the mezzanine financing methods that would be most suitable to use in Estonia are presented.

The next section, empirical study, will provide information of real life situations and methods that have been currently used in relation to mezzanine finance in Estonia. This section will also provide discussion and recommendations of methods and tools that could be easily utilized by Estonian real estate developers in the current market situation. Finally, findings of the study will reveal the most important highlights of the research with pointing out aspects for further research.

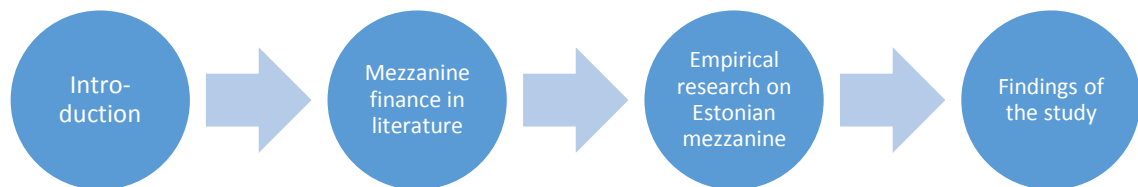


Figure 1. The structure of the research

2. Mezzanine finance in literature

In this chapter basic concepts of real estate finance and capital structure are presented, which are essential to move on and understand the essence and necessity of mezzanine finance. The following chapter will also introduce that capital could have the role of either debt or equity or both of them combined.

2.1 Capital structure

In order to cover the area of mezzanine financing methods we will quickly cover the area of traditional capital structure in real estate transactions in order to lay clear foundation for later stages of study concerning mezzanine finance.

It has been found that one of the key determinants of return on equity in real estate projects is financial leverage. Studies show that as long as the costs of leverage are lower than the initial rate of return, positive aspect through additional leverage could be achieved. (Brueggeman and Fisher, 2011, p. 339-340.) Basic principles of financial leverage are not explained further in this literature review, however, financial leverage is considered as one of the preconditions to earn higher return in real estate investment or development projects.

Financing structure or capital structure as it is often called, is a proportion of net debt to equity in company's balance sheet and in general capital structure could be divided into two major sections: debt and equity. That is also how sources of capital are divided in general: debt markets and equity markets (Figure 2). Both markets have their own dominant players providing and receiving capital. Debt market is a market where participants can issue and receive new debt. Debt received from debt market has different qualities than equity received from equity market, therefore, these two markets are considered separately. For example, by issuing debt by an investor for a specific company the investor receives fixed interest and principal payments, but no controlling rights and no rights for future profits, whereas issuing the same sum in the form of equity, the issuer is entitled to future profits and has controlling rights over the investment.

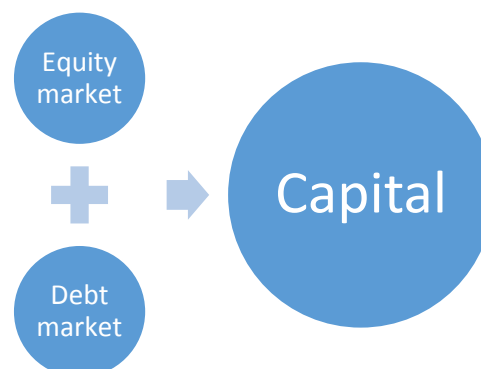


Figure 2. Debt and Equity Market

In the following section a non-complete list of some most known equity and debt financing methods will be provided as these are the traditional financing methods,

which help to move on later to mezzanine financing methods. The latter are seen as alternative or additional financing method.

Equity by one definition is ownership interest of common and preferred stockholders in a corporation (Ross et al., 2012, p. 12.). Equity defines ownership where the holder has certain rights over the overall direction of the firm and the disposition of the residual assets at the liquidation of the company (Swanson et al., 2003, p. 2.). The traditional method to receive the ownership in a company is to inject owner's capital in the form of equity to the company or into real property transaction directly.

Common equity is normally the first source of capital for business. Common equity is traditionally the investment of the owner to the company and this capital will receive return if all other obligations in the company have been fulfilled. Meaning that senior debt, mezzanine debt and preferred equity holders have fulfilled their claims. (Brueggeman & Fisher, 2011, p. 339-340.) Most important feature of common equity is that it provides rights of ownership of the company. This, in theory, means that the owner is also justified to receive the highest output on investment, but in return holds the lowest ranking to assets in the case of bankruptcy. Also, dividends are not pre-specified with common equity as they are with preferred equity, meaning that the common equity owner might not be entitled to dividend payments at all, whereas the preferred equity owner is. (Cumming and Johan, 2013, p. 41-42.)

Preferred equity has different ranking from common equity. In exchange of capital contribution to the real estate property in the form of preferred equity the investor receives certain "preferred" rights. Berman (2005) notes that these rights could include:

- receiving certain or higher rate of return on capital than common equity
- right to accelerated repayment of its initial capital contribution than for common equity

Structurally, all preferred equity members are subordinate to all creditors of the borrower (secured and unsecured), but are senior to common equity holders. Important feature of preferred equity is privilege to receive dividends and cash-flows before the common equity members. This is an important feature while the property is performing well, however, if the property is underperforming the preferred equity holders have the right to take over the control of the mortgaged property or the right to remove the voting rights of the common equity members. (Baker and Filbeck, 2013, p. 400.)

Preferred equity only has value if the firm is able to pay principal and interest on debt. Preferred equity holders rank behind debt holders, but ahead of common equity holders in the case of bankruptcy (Cumming and Johan, 2013, p.40-42). Preferred equity investments are useful in the cases when senior debt holders prohibit lenders need to take on any further debt through covenants, but additional financing is necessary, but also in the cases when the real estate property is generating insufficient cash-flow to service junior or mezzanine loan. (Baker and Filbeck, 2013, p. 400.)

Stock market is one of the best known sources of financing from the equity market, where companies list their stocks for public trading to gather additional financing by giving up some of the ownership (shares) in return of additional equity injection to the firm. Additional shares could also be issued, which dilute the ownership of existing owners, but by selling these shares on the stock market, additional capital is raised. (Quiry et al., 2011, p. 804 and 994.)

Private equity is another well-known source of equity financing. Worldwide, this term refers to asset class of companies that are not publicly traded on stock exchange. Often, this term is associated also with venture capital. The difference between private equity and venture capital is that, venture capital is been invested into companies in their early stage where a lot of risks are associated with the future and the companies that are being invested in do not have any other financing options. Private equity, on the other hand, is been invested into companies of any age and history. In their early age the young companies have no cash-flow to service debt, therefore, venture capital is associated with considerably more risk. (Cumming and Johan, 2013, p. 40-42.) For this reason venture capital is mostly associated with technology start-up companies, which have an idea to deliver, but not enough assets and history to involve bank financing. Venture capital is most of the time the only sources of financing for these type of companies. The high risk taken by the investors is compensated by potentially high return. Of course, if the company should succeed in its business operations as in the capital stack this capital takes the role of common or preferred equity, thus is behind other creditors of the company. (Cumming and Johan, 2013, p. 40-42.)



Figure 3. Equity market components

These previously listed options are presented all together in Figure 3. It should be noted that there are multiple possibilities to finance business operations using equity and previous examples should not be regarded as a complete list of equity market components. Although, if equity is not suitable way of financing for a company, then moving on from equity markets to other main source of capital. The debt market is the other main source for capital.

Debt, by definition, is a contractual arrangement between the lender and the debt holder, including principal payment(s), interest payments and maturity date (Swanson et al., 2003, p. 2.). The owner of the company by default should be determined to use as little equity as possible and as high leverage (debt) as possible if not considering the associated risk inherent with higher leverage, as higher leverage allows to earn highest return on equity. This leads to the optimal capital structure for a company or real estate investment capital structure. Optimal capital structure in the traditional sense is the financing mix that maximizes the value of the firm by using debt and equity, as most financing decisions, it involves risk-return trade-off, meaning that applying more risk (debt/leverage) could generate more return. (Baker et al., 2011, p. 400.)

By going more specific about the components of debt, senior debt is the first level of corporation liabilities, which means that it holds senior ranking to all other liabilities of the company. Senior debt is paid out first ahead of all other forms of debts and ahead of all other creditors. It is one of the safest methods for the creditor to provide financing as it is most often secured by collateral and therefore, it is most commonly used in the form of a bank loan. Due to the low risk level, it is provided with a low interest rate, but in large quantities as measured by the term of loan-to-value (LTV). If the company should turn to be insolvent and the assets liquidated, then the senior debt holder is the

first to get the debt repaid before all other creditors and equity holders. As the risk is low, the creditor receives normally fixed interest over period without any potential to earn return on highly-performing assets). The most common method of using senior debt is to acquire a bank loan. Other varieties of debt could include junior debt, bonds and other debt market instruments, which are examined closer in the following sections. (Structuring Finance, 2014)

Debt financing includes numerous other financing methods, which were not previously listed, but the focus of this study is on the financing possibilities that could lower the share of equity in the real estate development project, thus these financial tools should be able to provide more debt and less equity in the investment. The next sections will focus on the financing options that will fit between senior debt and common equity, as these are the two traditional financing methods and will determine the key options that are used in corporate finance to finance real estate development projects.

2.2 Alternative financing methods

With the turn of regulated lenders, who provide senior debt, becoming more and more conservative, especially after the recent economic recession in Europe and US, there exists a significant gap between the wishes of the borrower and the lender. Borrowers are not satisfied with the amount of capital provided for real estate acquisitions, as lenders require that owners provide 30% - 35 % of the value of the property in the deal, while many borrowers would like to limit equity share to 10-15%. (Watkins et al., 2003) Using less equity in real estate projects contributes to earning higher overall return on equity if the capital could be spread across different projects. Thus there exists a gap between the wishes of the lenders and the borrowers. A common universal name for financing method that sits between senior debt and common equity is called mezzanine debt (see Figure 4).

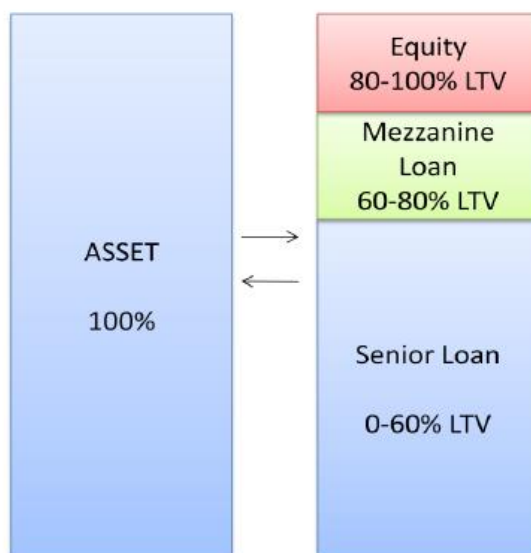


Figure 4. Capital structure with mezzanine finance as a part of capital stack (Krootila, 2012, p. 12.)

The origin of the name mezzanine derives from Italian name *mezzanino*, which means intermediate floor between two main floors and this word has its roots from Italian name *mezzano*, which means “middle” (Etymology Dictionary, 2014). The name perfectly describes the nature of the financing method it is used to title, as mezzanine finance with its characteristics sits between equity and senior debt. The main use of the mezzanine finance is to fill the gap between the needs and wishes of the lenders and borrowers.

Mezzanine debt, as it is also often called, has been used in corporate finance nearly 30 years. Mezzanine instruments became more known in the US during the 1980s, jointly with junk bonds and formed an important element of restructuring and fuelling up business projects. Since then mezzanine instruments have been widely popular in the US and Canada, however, in Europe and UK the popularity has not been so wide. (Willis and Clark 1989, p. 77.)

The need for mezzanine finance arises from the idea that senior lenders are normally willing to lend only up to 70% of the value of the real estate project. Whereas, by additional financing return on equity could rise remarkably. Therefore, investors are seeking possibilities to get that additional gearing to meet the required rate of return. It might be also the lack of required capital to meet the share of equity in the investments that leads to seek mezzanine finance. By occupying middle position between the equity and senior debt, mezzanine debt providers bear more risk than the senior debt provides but less risk than equity holders (Figure 4). (Willis and Clark, 1989, p. 77.)

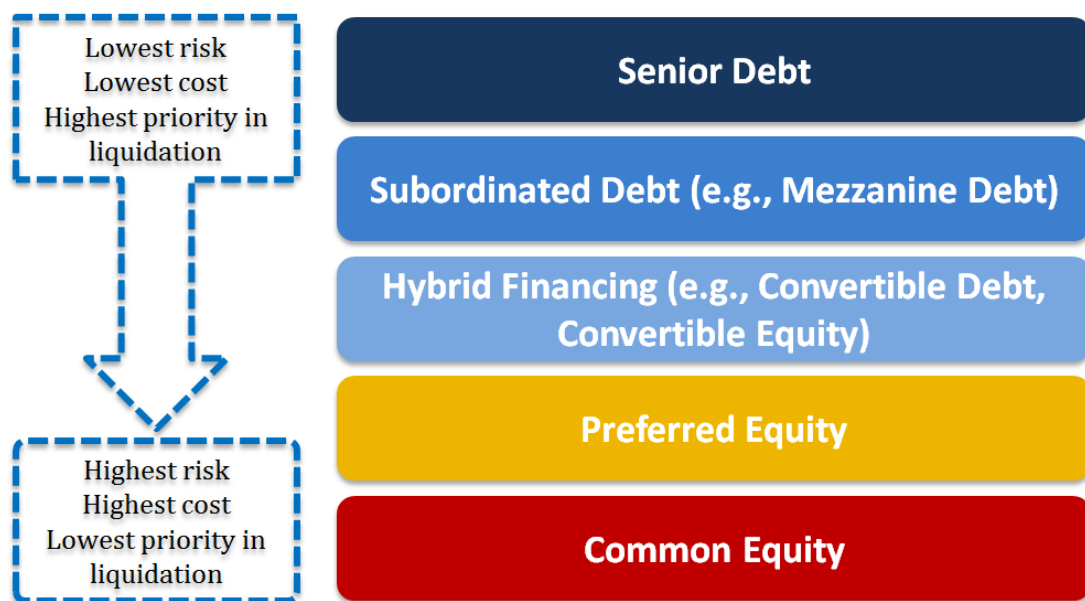


Figure 5. Different layers in the capital structure and their priorities in the case of liquidation (modified from Zhu, 2014)

This additional risk arises from the collateral that is left to be provided to the lender, as senior debt usually holds first ranking mortgage on the property, which makes the lending comparatively safe if the value of the collateral of the property exceeds the loan. Mezzanine debt holders might be provided with other collaterals such as second ranking mortgage or owners’ equity as a collateral, but these collaterals are not as valuable as first ranking mortgage on the property. However, they are still better than equity holders’ positions, who hold the lowest ranking in the case of liquidation. This position

of risk also reflects from the order of cash-flow payments. Senior debt lenders claim the debt service payments first in line, then mezzanine providers and in the end investors receive the residual. The same order applies in the case of default and liquidation of the property or the company. For bearing higher risk than senior debt lenders, the mezzanine financiers also expect higher return on investment. Typically it remains between 8- 20%+ range (Figure 5), while being very much dependent on the capital structure used in the mezzanine deal and the inherent risks in the property. (Watkins et al., 2003)

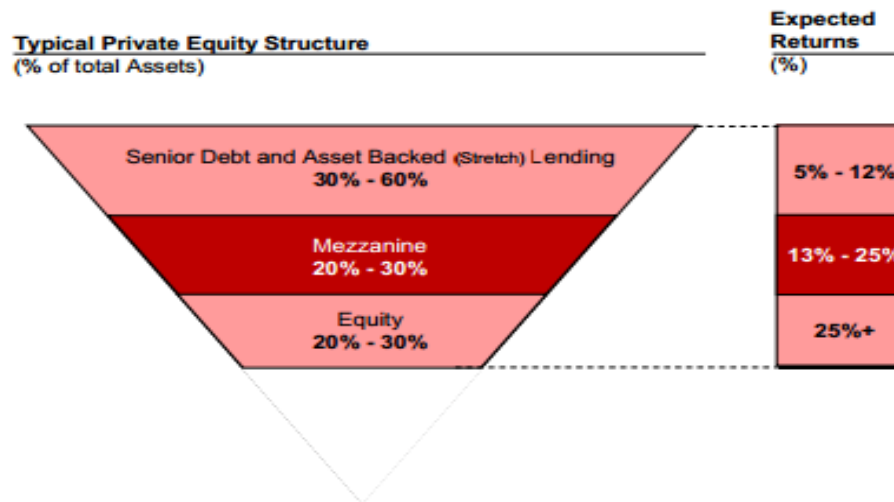


Figure 6. Effective use of capital (Silbernagel and Vaitkunas, 2014)

This chapter focused on the general position of mezzanine finance in the capital stack that comprises of debt and equity. Most common capital structures used in the mezzanine deals are discussed in the forthcoming chapters.

2.3 Structure of mezzanine deals

By default, there is no standard structure for a typical mezzanine deal, as every deal is tailor made taking into account both the interest of the lender and the borrower and thus there could be unlimited combinations of deal characteristics that make up the specific mezzanine deal. The possibility for academic encounter to mezzanine finance is to list up key elements in the deals that are most commonly used. These elements could be combined with each other to find the most suitable solution for the lender and the borrowers so that the interests of both sides are met. The key fundamental aspects start from the fact of whether mezzanine should be provided and structured as a debt or equity. Both options are possible in theory. By attributing certain qualities to the mezzanine deal, the capital takes either the form of debt or equity, depending which formation is more suitable taking into account specific conditions of the deal. (Watkins et al., 2003)

By handing over more controlling rights of the property and attributing less fixed periodical payments to the mezzanine lender, the capital takes the formation of equity, as lenders do not expect periodical payments, but instead, greater return in the future. In return lenders need to know that they are in control of what is happening with the

investment. Preferred equity and gap equity are most common equity-type mezzanine financing options. While providing the opposite, higher interest and less controlling rights, the deal resembles more of debt. In this case, the lenders do not need to be in control of the investment, if periodical compensation is set for the provided loan. Second trust debt and junior debt are most commonly known mezzanine finance, structured as debt. (Watkins et al., 2003)

Previously, it was explained that mezzanine finance could be structured either debt or equity on the balance sheet of the company. However, both options have their positive and negative aspects that should be regarded before structuring a mezzanine deal in a specific way.

Positive and negative aspects of using mezzanine finance over equity

1. Advantages of structuring the deal as mezzanine to full equity:

- **Equity amount** necessary to close the deal is lower (there is a difference whether 10 000 000 € or 20 000 000 € are necessary to close the deal). This leaves the project initiator more flexible to spread the equity among different projects. Additionally it allows to invest in larger projects with greater return. (Rosenthal, 2004, p. 65-73.)
- **Capped returns.** In situations, where a lot of value is created, as in real estate development projects, the borrower would rather pay a fixed interest than share the profits with the lender. In this kind of projects the borrower typically tries to achieve an agreement where mezzanine lender limits its profits and overall return of the project is not shared between the lender and the borrower. In situations where the expected increase of value is not so substantial, the situation is other way around, as large payments and high interest risk could be fatal to the project. In that case, profit sharing and hurdle rate in the exit phase is utilized to keep the running interest costs lower. (Rosenthal, 2004, p. 65-73.)
- **Less day-to-day interference** and reporting between mezzanine lender and borrower than there would be between equity investor and the borrower. Typically mezzanine lenders involvement is minimal as long as the debt service payments are regular. An equity partner would require more reporting and disclosure. . (Rosenthal, 2004, p. 65-73.)
- Generally mezzanine lender has **no controlling rights** over the property, which might change the management style. Such rights could include interference in the case of sale and refinance of the property, which is included in the case of equity partner. (Rosenthal, 2004, p. 65-73.)
- **Increase of yields.** In the case where the cost of mezzanine debt is less than leveraged IRR to equity for a transaction, the mezzanine debt has positive effect on the overall returns (Rosenthal, 2004, p. 65-73).
- Banks look more favourably on the companies that are backed by institutional mezzanine lenders with good reputation, as it reassures the credibility that in case of economic downturns, investors have capital and knowledge to take more active role in the investment if there would be a need for that (Silbernagel and Vaitkunas, 2014, p. 1-9.).

2. Disadvantages of using mezzanine capital over full equity:

- **Full subordination of equity, cash-flows and future returns to mezzanine debt.** This subordination reflects most of all on the initial free cash-flows to the borrower. Mezzanine debt has an effect of grabbing the cash-flows in the initial phase and leaving more remaining in the later stages of the investment if the cash-flows could be successfully raised by the operator. (Rosenthal, 2004, p. 65-73.)
- The **horizon of investment is generally shorter** than with equity partners. Mezzanine debt typically has a horizon between two to five years. Equity investors at the same time, typically have longer investment horizons and may hold the property as long as ten years. Sometimes forced property sales might be triggered by terminating mezzanine loan, which cannot be refinanced in unfavourable economic conditions. A flexible equity partner avoids some of these concerns. (Rosenthal, 2004, p. 65-73.)
- The **closing process is more complicated** for the mezzanine loan, as it often includes inter-creditor agreement between first mortgage lender and mezzanine lender. The negotiation between these two parties could be time-consuming process. This makes closing the transactions extremely difficult if it is being sold with favourable price and the buyer is not willing to wait. (Rosenthal, 2004, p. 65-73.)
- **Flexibility is limited** in the case if cash-flows should drop. Mezzanine lender terms typically are rather rigid and if the cash-flows should drop for some reason or the borrower is not capable to service mezzanine debt, the mezzanine lender could easily take over equity position and become the new owner of the property. If the gap is filled with equity, then the equity partner is typically willing to wait until economic condition is recovered (Rosenthal, 2004, p. 65-73.)

The main concept for the mezzanine investor to provide mezzanine loan is to gain return through the mezzanine investment by receiving either running interest or equity share in the company, which in turn could be liquidated in the future. Of course two of these possibilities could be combined. For the potential investor interest return could be achieved by attaching following instruments to the deal:

1. **Cash interest:** a periodic payment of cash based on the percentage of outstanding debt. The interest rate could be preliminarily set or be floating based on EURIBOR or other base rates. (Silbernagel and Vaitkunas, 2014, p. 1-9.)
2. **PIK interest:** „Payable in kind“ – PIK interest is a periodic form of payment, but instead of cash interest it is accrued as principle and paid to the lender at the maturity (e.g. 100 M Euros loan with 5% PIK interest will have 105 M Euros outstanding balance at the end of the year). (Silbernagel and Vaitkunas, 2014, p. 1-9.)
3. **Profit sharing over hurdle rates:** right to receive certain amount of profit over the previously agreed hurdle rate of the project. (E.g. lender and borrower have agreed that profit over 12% IRR will be shared 50/50 when the project has gone through exit phase). (Silbernagel and Vaitkunas, 2014, p. 1-9.)

Another attraction for the investor in mezzanine deals that will add positive effect and will lower the risk is **equity (ownership) conversion attributes**. By acquiring some of the ownership of a company, investors could boost up the IRR of the investment as equity in the company earns highest return and also add protection against possible defaults and insolvencies, where the investor could become the new owner of the property in case of real estate. Hence, the attributes used to provide previously explained equity kickers are:

1. **Warrants:** right to purchase or gain some amount of equity at a given moment
2. **Convertibles:** right to convert debt into equity at a given moment
3. **Participation pay-out:** instead of equity, the lender might ask the borrower for equity like attribute, where the lender receives a percentage of the company's performance, as measured to total sales or net operating income. (Silbernagel and Vaitkunas, 2014, p. 1-9.)

The previously listed attributes of different mezzanine instruments are just some of the features mezzanine finance provides and if used together, unlimited options of structuring specific mezzanine deals exists.

2.4 Tools of mezzanine finance

In this chapter, the focus is on mezzanine instruments that are used in Europe, while secluding the instruments that can only be used in the US market due to different legal framework that is not applicable in the Baltics and Scandinavia. As the focus of this study is set on Estonia and where the investigated methods are planned to be used. This exclusion includes for example second lien financing, which is used as mezzanine finance tool in the US.

1. Junior debt:

By providing junior debt, sometimes referred as subordinated debt, mezzanine provider takes the role of lender to the borrower and asks fixed interest for the compensation of providing capital. Based on the international experience, the interest rate for junior loan could be in the range of 8% to 12% and the mezzanine tranche enables the rise of the LTV to 70% - 80% of the deal value. (Watkins et al., 2003)

Junior debt could be also issued at fixed or floating rate, including an equity option or profit sharing scheme. Equity option means that some or all of the loan could be transferred to equity and the investor will gain the same return as the rest of the equity holders or receive capital gain on the sale of the shares in the future. If the company already is or is getting to be listed on stock exchange. In addition, profit sharing could be included, which might include a hurdle rate i.e. some % of profit over specific hurdle rate is shared. For example if the hurdle rate 12% of IRR of the project is exceeded then the profit over 12% is divided 20/80, allowing the investor to receive 20% of the profit above 12% return. This allows the investor to receive a potential upside in the deal, allowing the running interest to be remarkably lower for the borrower. (Sturgess and Leen, 1991, p. 1-20.)

2. Preferred equity

In the case where the investors is willing to raise the LTV level to 80% - 90% level, a participating debt or preferred equity has found most common use. This method will provide mezzanine lender current yield that is slightly lower than in the junior debt case (8% to 11%), but in addition a requirement might by the investor of participation in the cash-flows in the amount of 10-15% and proceeds from sale or refinance, which overall raise the IRR for the lender to 15% - 18%. In this case the lender and the borrower enter usually into a joint venture agreement. This agreement will give the lender more control over the property operations and in the case of default, the agreement can regulate the mezzanine provider to take over the control of property and enable to prevent first ranking mortgage to take over the property in the case of foreclosure. (Watkins et al., 2003)

3. Convertible debt and warrants:

By definition, a warrant is a derivative security that gives the holder the right to purchase securities (usually equity) from the issuer at a specific price within a certain time frame. Warrants are often included in a new debt issue as a "sweetener" to entice investors. (Investopedia, 2014) Hence, the main idea of using warrants is to provide equity kickers to the lenders, who are willing to take the risk and provide a loan, which is subordinate to the bank loan and in return warrants allow the investors to change debt into equity at a given time moment to receive some return in the form of potential capital gain. The whole idea of warrants is to make the mezzanine deal more attractive to the investor, who could acquire some of the company at remarkably lower price than a market value in the future, however, the issuer has to understand that by issuing warrants current investors could come future partners in the company, which makes the management of the company more complex. (Lustman, 2011)

Warrants can be issued by both: public and private companies. One fundamental issue, to use warrants, is to determine the value of the company. Whereas determining the value on private companies is more complex than for public companies, which are listed on stock exchange. For the latter, a previous 5 day average stock price could be used to determine the value of the company. For private companies, to determine the value of the company is much more complex. In general warrants are used more in the private mezzanine deals and convertibles in the public mezzanine deals. Convertibles allow converting the debt into equity and thus this is somewhat different from the warrants in the bond issue, which allow using the option to convert debt into equity and still receive interest and principal payments, while convertible does not allow this. These rights of warrants are detachable and could be traded separately. Latter is the most important feature that distinguishes these two tools of mezzanine. Convertibles also leave the investor either a possibility to be an equity holder or a creditor. (Sturgess and Leen, 1991, p. 1-20.)

Convertibles can be callable, meaning that the investor has specific time frame during which exists a right to convert debt into equity. Also a put option could exist, meaning that during specific time frame investor has an option to sell back the convertibles to the issuer at a price above par at a certain point in time or within a certain time period. There exists a mandatory convertible that is turned into equity at maturity and a pre-IPO convertible, where the debt is converted into equity (shares) at a newly listed company.

Perpetual convertible is a form of debt where the convertible option does not have maturity. (Müller-Känel, 2003, p. 105-126.)

The reason to issue convertible debt is similar to warrant, adding convertible feature to the debt allows the borrower to receive lower interest than it would be possible in a straight debt case. In this case, young companies can postpone interest costs until they can afford to pay them. In addition to that, another important feature is the reduction of agency cost, by aligning the interest of the borrower and the lender if the lender can convert the debt into equity. (Müller-Känel, 2003, p.105-126.)

4. High-yield bonds:

Bank loans have generally been regarded by real estate developers as short-term financing options. Due to greater collateral demands by banks over a fixed-interest expenses, developers tend to prefer longer-term debenture (bond) lending options to finance their operations. Different studies have found that the real estate companies tend to employ long term debenture especially in the situations where the economic outlook hints of rising interest rates. Thus using a fixed rate lending instrument is profitable tool for the developer compared to a floating rate bank loan. (Beveridge, 1988)

Bond maturities can span up to 15 years in the example of Asian real estate developers, while bank loan maturities in the same region span up only to 7 years. In Europe, the average bank loan maturity is 4.5 years. (Angbazo et al., 1998) Therefore, long term bond debt secures the issuer fixed rate financing and offers additional security in the situations where the future interest rates are expected to rise. It also offers a controllable cost for the developer in the future, allowing to make more precise business plans, in contrast to bank loans, which tend to have floating interest rate tied to interbank lending rates such as EURIBOR. Bank loans also need to be refinanced over specific period leaving the borrower open to the risk of unfavourable refinancing terms at refinancing moment. (Lam et al., 2011)

To issue bonds successfully the most important factor is the credit worthiness of the issuer and the bond maturity. Other key factors affecting the issuance are the interest rate and price (thus the yield), secondary market situation and subscription amount. (Lam et al., 2011) These factors together are the key to successful or unsuccessful bond issuance.

The name “junk bond” is used for bonds that have no credible or practical collateral for the bondholders who subscribe for the bond. More common name for “junk bonds” are high-yield bonds. These bonds, however, are still popular among some investors as the lack of collateral is compensated by high yield. In real estate “junk bonds” are used to finance highly leveraged transactions or to offer working capital to young companies to fund their operations. High-yield bonds have found use also in mezzanine deals as traditional bond issuance with first ranking mortgage collateral is regarded as senior debt. (Müller-Känel, 2003, p. 105-126.)

High-yield bonds are somewhat similar to mezzanine instruments, but on the other hand, there are characteristics that distinguish it from mezzanine. Similar characteristics with mezzanine include high-risk that is reflected in high yield, but also subordinate nature in the event of default and cash-flow payments. The difference arises from the way these two ways of finance compensate for the high risk. While high-yield bonds are

issued at high-yield to compensate for the possibility of default, mezzanine deals use an option to convert debt to equity or other ways to be compensated with capital gain. In addition, mezzanine has second ranking to senior debt, while high-yield bond has no ranking at all and is structurally subordinate to all other creditors. (Müller-Känel, 2003, p. 105-126.)

From the perspective of the bondholder fixed interest rates are favoured in the case of falling market interest rate environment perspective, as in this situation the investor is locking the return for the future. The issuer usually sees the situation from different perspective and in this kind of situation developer or the bond issuer would like to leave the interest rate floating to gain from decreasing interest rate environment.

When interest rate movements are unpredictable and the bond-issuer and bond-holders do not reach suitable conditions to issue bonds, one possibility for the bond-issuer can be to offer to make bonds either “puttable” or “callable” before the maturity of the bond. The possibility to call back the bonds thus the name “callable” bonds offer the issuer possibility to repay the debt sooner than the maturity of the bond, to take on new debt with better conditions. On the other hand, puttable bonds allow the investors to sell back the bonds to the issuer when they wish to transfer their funds to more suitable investment vehicle. These put and call options have an effect on the yield of the bond respectively, depending which option is used.

Some companies might issue convertible bonds, which by nature allows to convert the bond into shares at a pre-defined price within a certain time period. These bonds could be issued with lower costs, but the additional cost is embedded in losing control over the company or the property. For investors, this type of bonds are attractive as they allow the investor to take part in the profit sharing of the investment and in the additional stock price increase if the company is listed or planning to go through initial public offering.

2.5 Positive aspects of issuing bonds over bank loans

Banking is more based on relationships, whereas bond issuer and bondholder seldom meet and the whole deal is organized by an agent. When the loan has been issued by the bank, the borrower is subject to rigid control and covenants, which may prevent the company to perform certain actions as selling the property, taking additional loan or paying dividends without the consent of the lender. The relationship between the bondholder and the issuer is somewhat less regulated and the bondholders have less power to affect the management of the bondholder. Exception to this characteristic are actions taken through the trustee, but this requires a quorum of bondholders to gather their voices to have some effect. (Lam et al., 2011)

Having less covenants is a rather positive aspect from the real estate developer's perspective, as the development process is full of changes and this might require to take quick changes, which might be inconsistent with the covenants of the bank loan and this directs developers to prefer bonds over bank loans in the development process. Another positive aspect of bonds is the maturity, having a fixed interest on a long term loan is a good tool to plan future interest cost, while floating rate bank loans that need to be refinanced sooner or later, leave developers open to interest and refinance risks. (Lam et al., 2011)

Negative aspects of using bonds entails legal fees and financial advisory fees in addition to setting up fees. Moreover, historical experiences have shown that default on the bond issue has more dramatic causes than the breach on loan terms. This might prevent the issuer from future successful capital raising from capital market. (Lam et al., 2011)

2.6 Collaterals used in the mezzanine deals

Mezzanine finance in practise is all about collaterals that could be provided to potential investors. Especially in real estate, where the financing is for real property there is always a possibility to use first ranking mortgage as a collateral, which is regarded as one of the most valuable collaterals by creditors. Usually, senior lenders acquire the first ranking mortgage as their collateral to senior loan, so the mezzanine investors are left with other collaterals the developer has to offer and depending on the strength of the collateral, the lower or higher is the price (interest) of mezzanine finance. (Watkins et al., 2003)

Collaterals that are used in the mezzanine deals could be divided into two groups, firstly the agreements that could compensate for the borrowed capital in the case of default, where borrower is unable to repay and collateral is liquidated to compensate the borrowed capital. Secondly, characteristics of the deal that allow the investor to gain from potential upside of the deal and thus reward the investor with higher return and in return lower the risk of the deal. The general outline of the collaterals in the mezzanine deal is that the better the security and the less risk inherent in the property, the lower is also the interest required by the mezzanine provider. (Watkins et al., 2003) A short overview of some of the collaterals required by mezzanine lenders is provided, however, this list is definitely not complete and should be treated as an example of some possibilities.

Deals that are structured more similar to debt instruments usually have one or multiple elements from the following list:

- **Second deed of trust** – this collateral is most desirable to the lender as it allows to foreclosure the property if the owner defaults on debt payments. Deed of trust is mostly used in the US and it is in essence very similar to mortgage, as both are used as collaterals with the property underlying asset. The main difference between the deed of trust and mortgage is that with the deed of trust, the property can be assigned to foreclosure without the permission from the court. A second deed of trust is second in the priority ranking to first deed of trust. The first mortgage lender typically is not satisfied with the issuance of second deed of trust as it diminishes the position of the first lender and thus this type of collateral is not very widely practised. Issuance of the deed of trust only has juridical status in some of the states in the US. In Europe deed of trust has no regulation, so using this as collateral in Estonia is virtually impossible. (Watkins et al., 2003)
- **Second ranking mortgage** - a type of subordinate mortgage made while an original mortgage is still in effect. In the event of default, the original mortgage would receive all proceeds from the liquidation of the property until it is been

paid off. Since the second mortgage would receive repayments only when the first mortgage has been paid off, the interest rate charged for the second mortgage tends to be higher and the amount borrowed will be lower than for the first mortgage (Investopedia, 2014). Second ranking mortgage tends to have value for the investor only if the first ranking mortgage does not exceed the value of the property. Otherwise, in case of liquidation first ranking mortgage holder acquires the capital from the liquidation and nothing is left for the second mortgage holder.

- **Assignment of partnership interest** – This is one of the most common collaterals used in the mezzanine deals, also referred as share pledge, where the lender can through a contract take over borrowers interest in the property in case of default. By taking over the equity holder position the lender becomes the owner of the company or project and is responsible for the obligations to the senior lender. This contract transfers all the rights, title and interest. (Watkins et al., 2003)
- **Cash-flow note** – this recorded instrument allows the lender to receive cash-flow proceeds from the property in exchange of mezzanine loan proceeds and proceeds from the sale of the property. Also called soft second. (Watkins et al., 2003)

Mezzanine deals that have similarities to equity placements use different type of collaterals, for example:

- **Partnership agreements** – major provisions in these agreements cover the decision making process and regulate which decisions require creditor agreement. This provision diminishes the ruling power of the investor over the course of investment and might withdraw the investor completely in the cases where the property is not performing as expected and is near to default. (Watkins et al., 2003)
- **Intercreditor agreement** - Intercreditor agreement has the most importance from the viewpoint of mezzanine investor and therefore the mezzanine lender is the most interested party to sign this kind of an agreement between the senior lender and mezzanine lender. Intercreditor agreement provides a tool of communication between the senior lender and mezzanine lender. It is reached through negotiations and might provide certain right to the mezzanine lender in the case of default. The nature of this agreement is to protect mezzanine investor in case of default from the interests of other creditors that might overrule mezzanine the interests of mezzanine investor. It might be that first mortgage lenders refuse to negotiate intercreditor agreement, especially in the case if the loan agreement is already signed and mezzanine investor is stepping in afterwards. It has been proven to be successful to sign an intercreditor agreement in the cases where senior lender realizes that mezzanine lender brings synergy to the investment, especially in the case where the lender is experienced in real estate investments and if the investor is not. This mitigates the risk of default and adds confidence to the senior lender that in case of hardship, mezzanine investor is capable of adding more capital or knowledge to

the project, which might prevent the business operation to default. (Watkins et al., 2003)

In the case, where senior lender is willing to proceed signing intercreditor agreement, then some of the elements the agreement might consist and the mezzanine investor should require are following. (Watkins et al., 2003)

- **Notification of non-payment or default on first mortgage.** This ensures that the mezzanine lender will receive the information on time and from the direct source in the case where the lender is in delay or in trouble with the debt service.
- **The right to cure any default on the first mortgage.** This right provides the mezzanine lender take over the investor's position and eliminate the possibility of the property being sold through foreclosure.
- **The right to foreclosure the property.** This right could be exercised in the event where the lender fails to pay to mezzanine lender and mezzanine lender would like to retain the investment. This clause is hardly ever agreed by the first mortgage holder as it creates too much uncertainty from the viewpoint of the senior lender. (Watkins et al., 2003)

2.7 Conclusions on Literature review

The target for literature review was to search and point out what type of mezzanine investment options has been used in international practise. As a result, it is possible to assert that the international practise of using mezzanine finance only spans back a few decades and the deals have been mostly used in highly-leveraged buy-outs. The practice of using mezzanine finance extends from financial sector to more specific real estate sector, where mezzanine finance has found use in real estate cash-flow projects, but also in real estate developments. The literature on the subject was existent, however, not to wide. The subject of the literature reviewed was mostly focused on long term real estate investments and not so much on financing issues of real estate developments. However, argumentation and logic in the papers used was similar to the current research.

It was possible to point out that mezzanine finance in general could be involved in the deal in the form of equity or debt, depending which possibility is more suitable for both parties in the agreement. Using mezzanine finance in the form of equity strengthens the balance sheet of the company and allows to take on even further leverage, but also a greater share of profit is to be rewarded to the mezzanine investor. Moreover, management of the business operation might be more complicated if the mezzanine investor is interested to be involved in the administration of business. Positive aspect of equity type mezzanine financing is inherently lower running interest and debt service in total, which in turn lowers the risk of default, if the company should encounter difficult times.

Including mezzanine finance in the form of debt, the borrower is not obliged to profit sharing and in theory could earn higher profit on the project by being able to fix capital costs, but it also increases the risk of default, if the business plan does not realize as planned. There are several ways how to involve mezzanine finance in the deal in the form of equity such as preferred equity, which gives preferred equity owner more rights than common equity owner, but still subordinate nature to senior creditors. Also warrants and convertible debt have equity characters allowing debt to be converted into equity, which enables to earn higher return on investment compared to fixed returns on loans with fixed terms.

High yield bonds are considered as mezzanine instruments in this research, if they fulfil criteria of being used in a deal where senior loan is already existent or is being planned to be used. In that case, high yield bond i.e. bond without collateral or bonds with collaterals, sits between equity and senior loan in the capital stack, which is the definition of mezzanine finance. Another debt-like mezzanine instrument used in the financial sector, which was investigated in the previous chapter, is subordinated loan, that is very similar to senior loan, but with subordinate nature. Thus in case of default, the probability to receive the invested capital is smaller. This risk generally in this kind of agreements is compensated with higher interest rate and intercreditor agreement.

3. Empirical research on Estonian mezzanine

Empirical part focuses on the information provided through interviews conducted with top Estonian financial specialists and further analysis of the acquired information. As literature based information on the history of Estonian mezzanine capital is practically non-existent, therefore, very valuable statistics was received during the interviews.

3.1 Interviews

In order to gather information about the usage of mezzanine finance at the moment and in the past, Estonian top financial specialists were contacted and asked to participate in the interviews with the researcher. The list of contacted people consisted of 15 companies, which covers all known financial advisories across Estonia. The criteria for selecting initial candidates for the interviewees, was the participation in financial advisory and capital raising services sector. One of the contacted participants is also Estonian origin bank, which is offering mezzanine finance itself and the goal of the interview was to understand the principles of lending institution, which provide both senior and junior loan. As this is the case for the interviewed bank, they offer both senior and mezzanine loans.

Some of these companies, which were interviewed are operating in all three Baltic countries (Redgate Capital, Porta Finance), as well as in the Scandinavia (Keystone Advisers). The result of initial contacting process was that 9 companies out of 15 informed that they do not have had any experience with mezzanine finance in Estonia and thus waived the option to participate in the interviews. The rest of the contacted specialists were willing to participate in the interviews and contributed valuable information for the completion of this research. All of the interviews were conducted in Tallinn, Estonia in November and December of 2014 and they took place in face to face meetings. Interviews were recorded electronically and took approximately 45 minutes each. In the tight

Timeframe of this Thesis interviewees did not have time to oversee and modify their answers.

The specialists who participated in the interviews were:

1. Veiko Hintsov, Deloitte
2. Arvo Hallik, Superia
3. Aare Tammemäe, Redgate Capital
4. Stanislav Gutkevitsh, Keystone Advisers
5. Karl-Erik Kodu, Porta Finance
6. Indrek Nuume, LHV Bank

Veiko Hintsov is a Partner of Deloitte Estonia. He has been 18 years with the firm and has a deep understanding and experience in both international and local accounting standards. Veiko is a certified auditor since 1995 and a member of management board of Estonian Board of Auditors since 2008. He has been facilitated in several accounting and auditing seminars and being speaker number of conferences and trainings.

Arvo Hallik has spent majority of his career in investment banking business and has over 13 years of experience advising M&A, ECM and privatisation transactions. Arvo has played a senior role in many M&A transactions including TeliaSonera's public takeover offer and squeeze out of significant minority shareholders in Eesti Telekom and subsequent de-listing of the company, structuring and execution of Carlsberg's mandatory takeover offer, squeeze out and de-listing of Saku Õlletehas, and sale of Eesti Raudtee to the Government of Republic of Estonia. Arvo has been involved in majority of ECM transactions executed in Estonia since 2000, including IPO-s of Arco Vara, Ekspress Grupp, Nordecon, and Tallink. His experience includes advisory work to City of Tallinn on the privatisation of 12 facility management companies and sale of Tallinna Vesi to consortium of International Water and United Utilities. As a team member Arvo has advised Dalkia International in its successful tender offer for 30-year enterprise lease of Tallinna Soojus. Arvo holds a BA in International Business and Finance from University of Concordia in Tallinn.

Aare Tammemäe has a distinguished and long-term experience in banking, real estate and financial sector which he has acquired while working in a number of Nordic and Baltic top companies since 1992. In addition to the acquiring MBA degree in the Bentley Graduate School of Business in the USA, Aare has worked in Talinvest Suprema Securities's and as a Chairman of the Estonian Compensation Fund. In 2001, Aare continued his career as a financial manager in a company with one of the largest business turnover in Estonia: the Port of Tallinn, after which he started to work in banking, working as head of Corporate Banking in Nordea Estonia. Prior to joining the team at Redgate, Aare worked as CFO and CEO in Arco Vara Real Estate.

Stanislav Gutkevitsh joined Keystone Advisers in 2006 and has been involved in preparation and execution of several M&A transactions. Prior to joining Keystone he worked as a corporate client manager in Hansapank (Swedbank). Stanislav studied economics and business administration at the University of Tartu.

Karl-Erik Kodu is Director of Corporate Finance in Porta Finance, which is one of the most experienced financial advisory services in the Baltics and in exclusive alliance with Rotschild. Before Porta Finance, Karl-Erik has been involved with Evli Bank, Gild Bankers and SEB.

Indrek Nuume is head of Private and Corporate Banking in LHV Bank, which is largest Estonian based capital banking institution in Estonia. Previously Indrek Nuume has worked over 10 years as Director of Corporates and Institutions in Danske Bank. Indrek holds MBA from the University of Tartu.

3.2 Purpose of empirical research

It was established in the first part of this study that the research work is concentrated around the idea of mezzanine financing possibilities for real estate development in general and the purpose of empirical part is to answer to research question and supporting questions by conducting empirical study and analysing gathered information.

It was stated earlier that the research question of this study is:

- What possibilities Estonian real estate developers have in practise to use mezzanine financing in real estate development projects?

Supporting questions that help to answer to the main research question are:

- What are the theoretical mezzanine financing methods (covered and answered in literature review part)?
- Which of these financing tools (methods) have been used in Estonia?
- Which of these methods could be used in the current market condition?
- What are the terms to be fulfilled from the point of view of the developer to receive additional financing?

This part of research will seek to answer to the questions set in the beginning of the study, utilizing information and ideas collected through qualitative interviews with Estonian top financial specialists.

3.3 Defining mezzanine finance

In the beginning of the interviews, the first goal of the questions asked was to define the understanding of mezzanine finance among the interviewees. For that reason participants were asked to explain the concept of mezzanine finance to their understanding. Even though the interviews were arranged beforehand with Estonian top specialist in the field, the question of mezzanine finance stumbled practically all the participants at first, but answers about the concept followed eventually.

The most common way to explain mezzanine finance nature was by stating that mezzanine finance is a type of financing method which is used when senior loan is already present in the deal or business project and mezzanine is the additional financing method that lies between senior loan and equity. In addition, one participant pointed out that in order to qualify as a mezzanine, the financing deal should carry at least one or some of the following features:

1. Running interest (cash interest)
2. PIK interest
3. Equity kicker of some sort
4. Lower ranking to senior loan (subordination)

It was also stated that without subordinate nature, the financing capital is not mezzanine and it is subordinate ranking in collaterals and cash-flows that helps to distinguish true mezzanine capital.

One interviewee pointed out that mezzanine could be structured either debt or equity, depending which option seems to be more appropriate taking into account the nature of the deal. Meaning that, if the balance sheet of the company is weak, taking on additional loan could not be acceptable by the senior lender and the additional financing is more suitable to be acquired to the company in the form of equity. That of course could complicate the management of the company, but it is the price to be taken if additional financing is necessary.

All the participants in the interviews were aware of the theoretical nature of mezzanine finance, but only a few had any practical experience of constructing a mezzanine deal in practise in Estonia.

3.4 Mezzanine instruments that have been used in Estonia

All the participants agreed with the fact that mezzanine finance in general in Estonia is a rather exotic phenomena. It is partly because on the demand side, companies and their management are not aware enough to ask for this kind of financing deals from the financial advisers. Also, it was confirmed, that several financial advisers have been offering to set up mezzanine deals as a part of their services, but interest to use the possibility has been extremely low. Therefore, in the last 10 years only a few specific mezzanine deals could be mentioned that are publicly known in the Baltics by the financial advisers. However, LHV Bank, claimed that they have been providing mezzanine loans and at the moment of the interview had two outstanding loan agreements, which were structured as mezzanine finance.

When the interviewees were asked to list forms of mezzanine, that they know have been used in Estonia, following list could be created:

1. High-yield bond (if used in addition to senior loan)
2. Subordinated debt
3. Subordinated debt with equity kickers
4. Vendor note

After the interviews it was clear that use of mezzanine finance in Estonia is extremely underdeveloped. Participants pointed out that partly it is the entrepreneurs who are not aware to ask for additional financing methods, even from the banks. On the other hand, some the mezzanine financing deals that were almost carried through were cancelled by the senior lender, who was not willing to finance the deal if the contract involved third party (mezzanine investor). The senior lender argumentation to refuse this kind of deal was based on the fact that third party in the deal adds uncertainty and at some point it is theoretically possible that the mezzanine lender takes over the investment if the borrower defaults and in that case the senior lender is forced to continue with mezzanine investor. New owner of the project might not be as competent to lead the process as the initial owner. Contrary to this, when interviewed a local institutional mezzanine provider, it became clear that when signing an intercreditor agreement between senior and junior lender, some of the ground rules could be set. Including, what are senior lender and junior lender rights, when borrower runs in difficulties. This agreement is crucial part in a deal, which involves several lenders.

In another case, where mezzanine financing was planned a part of the deal, the bank refused to be senior lender, finding out that there is mezzanine finance involved in the form of vendor note, bringing argumentations that the deal is too complicated on the one hand and the size of the deal is too small. In later interviews with institutional investor, this fact was confirmed that the bank is looking for greater deals.

It was also mentioned by the interviewees that, the willingness of the senior lenders to participate in mezzanine deals is very much related to the size of the deal. It was supposed that the magical line of the total value of the deal should be around 3 M Euros, for the banks to be interested to participate in the scenario where third party financing is also included. However, interviewees stated that most of the real estate transactions in Estonia are in the range of 1-2 M euros and over that amount are only a handful of transactions each year, those of which almost all are liquidations and acquisitions of cash-flow projects, staying out of the scope of this study, which is financing real estate developments. The bottom line of the studies were that so far in Estonia the track record in constructing a mezzanine deal shows that branches of big Scandinavian banks are not interested to take part of small local mezzanine deals and the interested of local companies to acquire mezzanine is extremely low.

The reason, why banks and investors are being extremely conservative lies in the fact that the biggest financial institutions in the Baltics are actually Swedish banks: SEB (Skandinaviska Enskilda Banken) and Swedbank. The market share for Swedbank by their balance sheet size in Estonia in 2013 was 42% and for SEB at the same moment it was 19.7%. Other large foreign banks at the same moment in Estonia were Nordea, which market share was 15.7% and Danske Bank with 10.7% (Estonian Bank Association, 2013). Together these foreign banks dominate the banking market and take up to 88.1% of Estonian lending and deposit market. These financial institutions suffered severe losses in the last economic recess in 2008 and 2009, which followed the largest financial boom Estonia had ever encountered during 2004-2007. What happened then, was that these large banks distributed extensive amounts of capital to private individuals and corporate institutions in the form of loans, which in turn made the real estate market soar as never before. The extensive capital was also invested in different financial instruments, one of them was relatively new element in the newly developed Estonian financial market: corporate bond.

In the years 2006 and 2007, each year over 100 different bond emissions were conducted. For the note, in recent years the number of emissions has been only around 10 emissions per year (Redgate Capital, 2014). During that period (2006-2007), bond emissions were popular and investors were seeking new ways to earn higher return. However, as a result of worldwide economic crisis and recession that followed, combined with too bold extension plans in the former Soviet-bloc, most of the bond emissions in Estonia ended with investors being left bare-handed. According to one interviewee, banks had important role in this situation, while they had firstly provided corporate loans to the companies, which also emitted additional corporate bonds. These bonds were acquired by the bond funds and pension funds of the same banks. As a result of the recession, the banks found themselves in a difficult position where only one part of bank investments could be partially saved: either the corporate loans or the investor's capital invested in the bonds. This resulted in severe losses for almost all of the major foreign banks by either writing off the issued loans or compensating investors for the losses of their investments through the debt funds.

As a result, the amount of new bond emissions has dropped dramatically, as most of the bonds defaulted in the latest recess period. Therefore, bond emissions acquired rather negative reputation in the eyes of the investors for some period. This perspective has not changed until this date as can be seen from the Figure 6 below, which represents the amount of new bond emissions in Estonia from the period of 1993 to 2013.

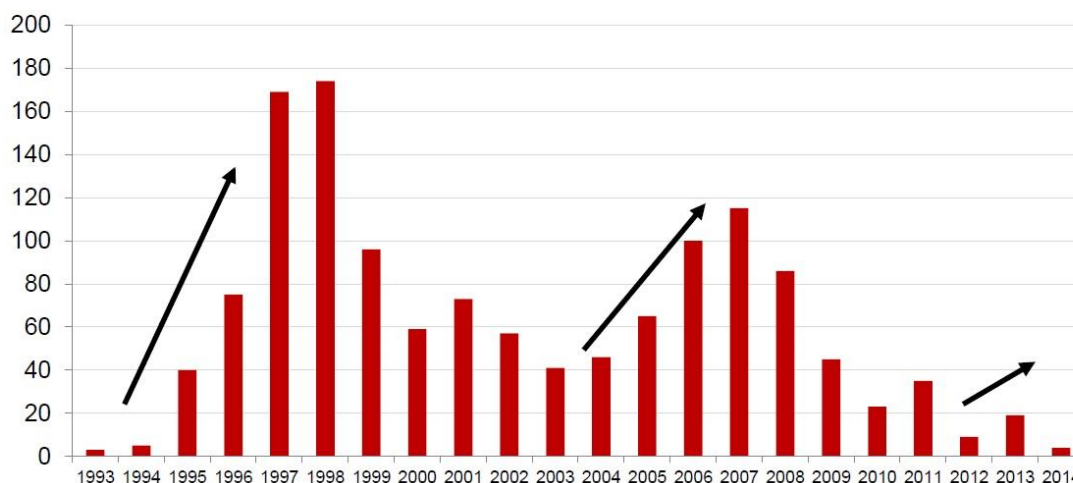


Figure 7. New bond emissions in Estonia from 1993 to 2013 (Redgate Capital, 2014)

The figure dramatically illustrates that there were two high periods in Estonian debt market, in the end of the 1990s and 2004-2007. Compared to those periods, the participants in the interviews have said that Estonian debt market is extremely underperforming at the moment. The reason lies mostly in the investor confidence, which was affected by the dramatic events only a few years ago, where majority of private individuals, who are the target group for new bond emissions, got negatively hit. However, additional effect has the fact that Estonian market lacks of professional investors, who would purchase new debt in large quantities. Therefore, it was claimed by the interviewees that bond market is not considered as common instrument to acquire capital in addition to bank loan in Estonia, as it is for example in the US and UK.

3.5 Professional institutional investors in Estonian financial market

Results of the interviews reflected another common nominator of Estonian financial market, which could explain why only a handful of Estonian mezzanine deals have been carried out so far and why capital and debt markets are in such weak condition as they are at the moment.

According to one interviewee, the environment of Estonian professional investors is extremely scarce and according to interviewee institutional investors in Estonian capital market currently could be considered to belong in following groups:

1. Pension funds
2. Debt funds
3. Investment companies

The problem with the pension funds to invest in Estonian debt lies in the reason that nearly 90% of Estonian banking is controlled by foreign banks, which pension funds are

governed from head-quarters is Sweden or other Scandinavian countries and these pension funds are pooled together, so the investment policy is somewhat mutual to all pension funds across all countries among one bank. This rule is enforced to keep the management costs lower. Furthermore, the investment criteria by Estonian financial advisers in these banks, is regarded to be top-down: the investment decisions are based firstly on regions, then by specific sectors. Estonia falls out momentarily from these suitable investment regions, due to lack of suitable investment opportunities with size that would fit the investments criteria. Large pension funds are seeking for investment opportunities starting at least 10 M euros according to the participants in the interviews. Unfortunately, most of the bond emissions and mezzanine investment sizes in the Baltics and Estonia fall below this level. In addition to that, there are another two obstacles set from Investment Funds Act that rules the investment criteria of pension funds in Estonia. The act sets that pension funds are not allowed to invest more than 10% of the total outstanding assets of the fund to unlisted investment vehicles and no specific pension fund is not allowed to own no more than 10% of one unlisted investment vehicle or company. These two rules under the current Investment Funds Act of Estonia more or less exclude unlisted debt securities from the investment options of pension funds, therefore pension funds in general do not have local debt in their portfolio.

The same rule also governs the next professional investor group in Estonia, brought out by the interviewees, which is local debt funds. There only exist a few funds the participants could name and these were: Kawe Kapital and Avaron (East-Europe Debt Fund). Although, the problem of these funds is the same as for pension funds as they are public funds, the current Investment Funds Act prohibits to make substantial investments into Estonian bond emissions and taking into account the average fund size, it is not attractive to invest into Estonia at the moment. The participants confirmed, that there have been information of a new Investment Fund Act to be approved by the parliament that would ease the current restrictions and in theory could raise the popularity of local debt investments.

Last professional investor group in Estonian Capital market is considered to be investment companies which only focus is to accumulate the wealth of private shareholders such as Ambient Sound Investments (ASI) or NG Investeeringud. These institutions are free in their actions to invest, as they are not overseen by the Investment Funds Act. The low activity to invest among these companies is connected to the low number of players among investment companies. Often these companies have their investment focus shifted to specific area, such as technology and start-ups for Ambient Sound Investments and retail business for NG Investeeringud. These companies are also seeking for equity investments and therefore are not active players in the debt market.

All of the participants in the interviews confirmed, that until these previously listed participants in the capital market are not involved in new bond emissions in the future, the debt capital market will not evolve any further from current position. At the moment practically all the bond emissions are unlisted and are subscribed by wealthy private individuals and companies mediating private individual's capital (including family offices). It was confirmed by financial advisers that in order to conduct listed bond emissions, existence of strong local debt investors is crucial, as in every listed emission a focal investor, who subscribes a majority share of the emission is necessary for the emission to be successful. Lack of this kind of local institutional investors, holds back

to some extent public bond emissions in Estonia, as it is crucial for the issuance success, that a strong investor takes part of the bond issue.

The Act of Securities in Estonia states that if the emission is advertised to under 150 investors, it falls into the limits of unlisted emission and no further restrictions are set. The same act states of minimum nominal amount for one investor to list in bond emission is 50 000 €. According to financial specialists, the idea of this act is to prevent unexperienced investors to take part from the emissions and that is what high nominal values should execute, but at the same time high minimum amount of investment also prevents debt market to gain further popularity among investors as in general context 50 000 € is too much for most investors.

One interviewee, who is specialised on bond emissions in the Baltic countries explained that if the total amount of emissions stay between 100 000 € and 2 000 000 € as they currently do most of the time, there is no need to organize public emissions to gain capital, as listed emissions are more expensive for the companies to run and subject to more scrutiny by Estonian Financial Inspection. It was said, that there is no need to organize public emissions, as with current emission volumes, capital is successfully raised in the limits companies expectations, even without public emissions. As is proved in the last few years, were no public emissions have been organized and most emissions fell below 2 000 000 € limit.

It was also mentioned by the interviewees that Estonian government could have an important role in enlivening the capital market by issuing government bonds. Other countries in the Baltics have gone this way by emitting government bonds or bonds by companies owned by the country. The fact of emitting government bonds plays an important role by providing investor confidence in the bond market and providing an opportunity to invest for local and foreign investors. All in all, the bond market will gain more popularity, which will allow new players enter to the market. The participants were convinced that until the government does not make an active move by issuing government debt or changing the Investment Act, local debt market will stay more or less where it is at the moment. Active role of government or government companies in the debt market could create spill-over effect in the capital markets and help to establish bond market as a source of debt for local companies.

Another possibility offered during the interviews to enhance Estonian capital market was the idea that banks could emit covered-bonds. Currently, banks have a large portfolio of well-performing home mortgage loans, which have timely interest payments. Banks could emit bonds covered by the mortgages on their home loans. This could be a popular product to invest even for large institutions, not to mention private individuals. The problem here is the negative reputation the mortgage backed securities gained in the US, where extensive use of mortgage backed securities was one of the reasons which triggered the global financial crisis. Therefore, the participants did not evaluate the likelihood of this kind of product to be released in Estonia not very high. In addition, this kind of decisions could only be made by head-quarters of large foreign banks, which carried severe damages in the last financial crisis, therefore the likelihood for this kind of product to be released is low.

It found mentioning that Estonia has been home to a few specialised mezzanine funds as well. Namely Hanseatic Capital, BPM Mezzanine Fund and Kredex (Estonian Government owned financial institution mainly to enhance export). Hanseatic Capital

was founded in 2003, dedicated to be provider of fixed income growth capital in Emerging Europe. It is headquartered in Tallinn, Estonia, and has representative offices in Bulgaria, Poland and Latvia. Currently the focus is set more on Polish investments. Hanseatic Capital has made investments in the past in the following Estonian companies: Olerex, Favor, Sunorek, Ortodontiakeskus and Tallinna Masinatehas. Currently, the investment focus of Hanseatic capital is mostly set in Poland and participants in the interviews could not point out any recent deals in Estonia with the involvement of Hanseatic capital.

BPM Mezzanine Fund is an Estonian fund, which is financed by European Investment Fund to enhance the growth of Baltic small size companies, by investing in the form of private equity, mezzanine and venture capital.

Kredex offers a subordinated loan, which is designed for an enterprise having proved the functioning of the business model and planning investment into development. It is designed to be subordinate to all other financiers (including bank financing), to increase the financing ability of young Estonian enterprises.

From these institutions only Hanseatic Capital has made publicly known mezzanine investments in Estonia in the past, but in recent years the company has not been active in Estonia any more. None of the interviewees could mention any conducted investments by BPM Mezzanine fund or Kredex.

3.6 Estonian bond emissions

Participants in the interviews agreed, that if bond emission are used in addition to senior loan to finance real estate development projects, it could be considered as mezzanine finance. Therefore, in this section Estonian bond emissions are covered in higher depth, as it was also stated that corporate bonds are one of the most likely possibilities for Estonian companies to involve additional capital. Even though bonds need not to be subordinate in their nature, as the definition of mezzanine finance would require, they still fit in the framework of mezzanine finance in the eyes of the interviewees.

As described in the previous chapters, bond emissions in Estonia have been rather rare in recent years, mainly due to the past, which has affected most of the investors, who would be investing in local bond emissions today. Participants agreed that the range, where large foreign institutional investors would be interested in Estonian or Baltic bonds, lies between 5 – 10 M euros. However, most of the emissions in Estonia fall below 5 M euro, therefore, the investors are mostly local private individuals through their investment companies.

Lack of new emissions reflects also from the shortage of financial advisers, who are specialized on bond emissions. There is only one company, which is publicly categorized as financial adviser to organise bond emissions that fall below 5 M euro limit and that is Redgate Capital.

According to the interviewees a few common nominators for current Estonian bond emissions could be summarized, which are explained further in the following chapter and these are:

- Practically all emissions are unlisted

- Whole emissions are subscribed by 1-10 investors
- Investors are mainly private individuals
- Bond emissions could be seen as pan-Baltic
- Average maturity of a bond is 1- 3 years
- The shorter the maturity, more popular the bond is
- Investors hold the bond until maturity
- Lack of liquidity, although theoretical liquidity exists
- Few advisers, who are specialised on bond emissions

Statistics from Redgate Capital and Estonian Central Register of Securities show that during the year 2013 new bond emissions were rather rare, which is presented in (Table 1).

Table 1. New Bond emissions in Estonia in 2013 (Redgate Capital, 2014)

Emitter	Field	Amount of emission (EUR)	Maturity	Number of investors	Nominal value (EUR)	Coupon rate	Coupon payments
AS LHV Varahaldus	Asset management	550 000	7 years	1	10 000	8%	Quarterly
Arco Vara AS	Real estate	751 000	4 years	8 (2 emissions)	1000	5% and 14%	Quarterly and yearly
AS Elcogen	Manufacture	14 949	1 – 1,5 years	2 (2 emissions)	7 693 and 10 256	10%	Yearly
AS IuteCredit Europe	Consumer loans	1 000 000	2 years	2	1000	16%	Quarterly
AS LHV Group	Banking	15 450 000	8 years	82 (3 emissions)	50 000	N/A	Quarterly
AS Pro Kapital Grupp	Real Estate	1 640 000	3 – 5 years	3 (3 emissions)	10 000	5%	Quarterly
Baltic Financial Group OÜ	Investment	3 300 000	7 years	1	10 000 SEK	7%	Yearly
Credistar Group AS	Consumer loans	5 000 000	2 years	20	1000	14%	Quarterly
Dental Invest Estonia OÜ	Orthodontics	1 980 000	2 years	4	1000	10%	Quarterly
Hüpoteek-laen OÜ	Mortgage loans	4 000 000	3 years	10	1000	8%	Monthly
OÜ Chester Universal	Real Estate	1 479 999	N/A	9	0,6391	N/A	N/A
Sharp Investments OÜ	Financial services	39 000 000	3 years	1	100 000	11%	Quarterly

Tartu City Council	Public sector	19 777 548	10 years	2 (2 emissions)	10 000 and 1	N/A	N/A
Valgevase 11a	Real Estate	1 242 000	1 year	2	1000	N/A	N/A

Analysing the information provided by Redgate Capital, a few common nominators could be drawn. Firstly, most of the emissions were carried out with less than 10 investors listing the bonds through offer. This fact was confirmed during the interviews as well. All in all, it supports the claim that at the moment public bond emissions are not necessary, as there are enough Estonian, Latvian or Lithuanian investors who would list the emissions without going public, making public emissions unnecessary. Redgate Capital confirmed, that the Baltic bond market works as a whole and due to network and office base in the three Baltic countries, bond emissions and investors should be regarded as region based, rather as country based.

Another common nominator among the emissions was that most of them are under 5 M euro limit, only 3 emissions were higher and the maturity for the same emissions was mostly 1-3 years, with a few exceptions. It was also confirmed by financial advisers, that local investors are seeking for short term investment opportunities, as confidence in long term economic movement has not been so high in recent years. The logic of the investors is to receive the money back before anything could go wrong, therefore, the shorter the investment period, the higher value it gains among investors.

From the emitters perspective at the same time short time bond is several times riskier than long term bond, as it is exposing emitter to re-financing and business risk. The possibility of economic change in short term and inability to refinance in short term is considerably higher than it would be in long term. At the same time international literature states that one of the advantages of bonds over bank loan is the average maturity, which for banks loans is from 3-5 years and for bonds could reach up to 15 years (Lam et al., 2011)

Asking Estonian financial specialists about the possibility to emit 15 year bond, the participants agreed that this would require emitter to be a consolidated holding company with understandable structure, having all the assets and projects in one company. This kind of company would categorize as suitable for institutional investors (like pension funds). Important aspect for this kind of bond to be emitted, is also functioning secondary market, which does not function at the moment in Estonia. Investors buy and hold the bonds until the maturity, although theoretical liquidity exists, as all the bonds are registered in the Estonian Central Register of Securities, in reality, bonds seldom change owner before maturity. Most of the Estonian real estate companies, at the same time, operate at the moment through various special purpose vehicles (SPV), which is a method to protect the holding company of possible defaults caused by one unsuccessful project. These three aspects together: unstructured companies, lack of institutional investors and non-existence of secondary market together as whole prevent long term bonds to be emitted at the moment in Estonia and most of the maturities stay around three years.

All participants in the interviews agreed that emitting bonds in addition to senior debt would be most realistic option to acquire mezzanine finance in current economic conditions in Estonia for a real estate development company. However, it was proven that those few attempts to conduct mezzanine deals in Estonia with bank involvement,

were troubled. Therefore, most realistic option is to acquire bank or senior financing first and mezzanine financing through bond emission after the senior loan is already present in the deal.

Good accessibility to capital acquired through bond emission could also be explained by the fact that is possible to acquire financial advisers to mediate bond emission and carry out the process. One of the advisers, specialised on bond emissions, stated that bond emission is a straightforward and understandable process for Estonian investors, who are mostly wealthy private individuals. All other mezzanine instruments might be too complicated to comprehend, hence, the lower popularity and usage of them. One specific company interviewed is specialised on bond emissions in every capacity, all other companies interviewed claimed, that they operate with bond emissions starting from 3 M Euros. Most of the real estate developments in Tallinn in total value stay below 3 M Euro level. Therefore, the company mediating most of the Estonian bond emissions has developed a well-working process, with pan-Baltic office base and good investor list. This well-established structure allows conducting bond emissions in all sizes.

When asked about the terms and preconditions the companies should fulfil to be eligible as favourable bond emitter and the bond emission to succeed, the interviewees pointed out, that is very much dependent on who is the owner of the company and how well known is the name of the company on the market. Most of the investors remember very well last economic crisis, where bond emissions and following bond defaults were very common. Therefore, extra attention and care is applied today. Thanks to the tight network of Estonian businessmen, the credibility and reputation of the business owner and loan taker might be the key to successful bond emission.

Second important risk factor investors are considering is the cash-flow the company is or is expected to generate. It was said during the interviews, that companies with well-functioning and positive cash-flows are regarded higher by the investor, as the risk of failing to service debt is lower than for a starting company with low or no cash-flow. In real estate sector, most of the developments are carried out in SPV-s, which have no positive cash-flow initially until the first sales are conducted, therefore, value of these starting development companies among investors are lower than companies that have all their operations in one company and their portfolio consists of core cash-flow projects. In difficult times, cash-flow projects could support development business by allowing to service debt from occurring cash-flows. Interviewees admitted that developers have weaker position to raise capital from bond market, but strong history on parent company (brand name) and good advance sales on the projects before bond emission support the successful emission of bond.

In addition, good reputation of the company in media was pointed out, which is especially crucial in the real estate sector, where many developers have been struggling with negative image in the media. Also, consolidation of the group of companies and their economic results, which allows receiving better understanding of the business operations, was pointed out, as it is widely spread at the moment that companies do not consolidate their SPV-s and business results. This is common practise due to the last economic crisis in 2008-2009, where downturn of some projects pulled under water whole companies. Current legislation in Estonia allows to operate real estate business by SPV-s, which all are separate limited liability companies, as in the case of default, other companies owned by the same owner will not be affected.

3.7 Collaterals used in bond emissions

For the same reason that most of the real estate business and other business in Estonia are operated in limited liability companies, the creditors are open to the risk that in case of default, they might be left bare-handed. This raises the problem of collaterals which could ensure the investor providing the capital that the loan could be received not only by being paid back by the borrower, but also by liquidation of collaterals. According to one interviewee, there are two aspects to be evaluated on the mezzanine borrower: willingness to return the capital and ability to return the capital. For the investor, both of these factors are important, but the willingness will be enhanced, if there is some collateral set for the investor, that the borrower considers important not to lose. Also, the collateral should have enough value, that in the case of liquidation, it could cover the loan amount.

To be considered as mezzanine, the definition implies the presence of senior loan in the project. At the same time senior lender practically always acquires the most secure collateral, which is first mortgage of the property if the financing seeking company is operating in real estate sector. The participants in the interviews were asked to name additional collaterals, which could be used in any mezzanine deal (including bond emission) and offered to the mezzanine investor to secure the loan. The following list of potential collaterals was collected:

- First ranking mortgage
- Second ranking mortgage
- Claims, which could include
 - Claims on mortgages
 - Claims on loans
- Share pledge
- Guarantee
 - From the holding company
 - From the owner of the company (as private individual)
- Name and reputation of the company

If corporate bond is considered as a tool of mezzanine finance, then it should be used together with senior loan, to qualify as mezzanine finance. In that case, senior lender is likely to acquire the first ranking mortgage on the property, exceeding or equalling the value of the property, therefore, in the sense of mezzanine deals first ranking mortgage cannot be used most of the time. Otherwise, all participants agreed, it would be the most secure collateral possible in the real estate loans, giving the investor highest confidence to take part in the deal. Knowing that in case of default, most probably the loan could be compensated in case of property liquidation.

Second ranking mortgage on the property, could always be set for the benefit of the mezzanine investor, however, the real value of this collateral could be low if the first ranking mortgage value is equal or exceeds the property value. As in case of liquidation, first ranking mortgage holder could collect the liquidated capital in the amount of mortgage value. Therefore, interviewees claimed, that it is useful to use second ranking mortgage if the first ranking mortgage is set below the market value of the property. In that case, the collateral has solid value for the investor and is regarded as realistic collateral.

Claims as collateral could include most often claims on loans and receivables. If the borrowing company has provided loans to other related or non-related companies and likelihood to receive the loans back is high, this kind of claims could be used as collateral on new mezzanine loans. During the interviews some Estonian examples were brought up where the companies that provide consumer loans and mortgage loans are seen as competitors and risky clients by large banks, therefore, the only option to acquire additional financing to expand business for this kind of companies is from the debt or equity market. These companies can set their claims on clients (loans provided to clients), as collaterals on their own loans that they acquire. As the client list is wide for these companies, the likelihood of all of the clients to default is low, therefore, the whole collateral status in general is regarded strong by the financial advisers. Even stronger is the position for claims on mortgages, as is the case for companies that provide mortgage loans to their clients and can use the claims on mortgages as their own collateral to get financing. This reflects also from the interest rate companies actually received in Estonia last year, emitting corporate bonds. IuteCredit Europe and Creditstar Group provide consumer loans mostly without collaterals, they emitted bonds with 16% and 14% respectively. Hüpoteeklaen OÜ provides short term loans to their clients, which are backed with mortgages, they emitted bonds with yearly interest rate of 8%. Previous example illustrates how investors evaluate the strength of collaterals and how interest rate is connected to that.

Collateral, which could have a great value or practically no value at all for the investor, is share pledge. If in case of difficulties with repaying the loan, mezzanine investor decides to use the collateral and acquires the shares of the company, the collateral could have real value if the company could be turned around and made profitable, or no value, if the company is left with no assets and no future potential. Therefore, the position of the collateral depends very much of the sector and company. In real estate sector, the most important asset of the company is the property and its potential, which could be harnessed as collateral through first and second rank mortgage. If these two collaterals are already used for the benefit of somebody else than the mezzanine investor, the share pledge has little value. If the mortgages are not utilized, share pledge could be very valuable in the eyes of the investor.

Guarantee on the loan could be in the form of holding or parent company assuring to guarantee to cover the loans provided to the related company in case of difficulties to return the loan. Additionally, the owner of the company could guarantee the loan taken as a private individual and be responsible with all assets held as a private individual, which could add extra confidence to the investor. Private individual claim that could turn into private individual default is something every individual would like to avoid. Therefore, the investor could be sure that the borrower will have maximum motivation to service the debt. The guarantee is not considered among the strongest collaterals, but it is still valuable among investors.

Final collateral named by the interviewees was the name and reputation of the company emitting the bonds. It was said that not necessarily the bonds without collateral (high-yield bonds), could be carrying the highest interest, thus regarded as highest risk bearing instruments. Interest rate depends very much on the company emitting the bonds. For example government companies or utilities companies with long history and strong balance sheet do not need to provide any collateral at all to receive loan with low interest, as the risk of default is little. Also, if the company is owned by a strong owner,

who could step in when things go for the worse, adds extra confidence to the investors even if no other collaterals are provided. Whereas, starting companies with risky business plan could not get nearly as good conditions even with all the collaterals mentioned before. It was confirmed by the interviewees that in a small country like Estonia, this last collateral, name and reputation of the company, might turn out to be the most crucial component for a successful bond emission.

3.8 Subordinated loan in Estonia

During the interviews, all of the participants agreed that subordinated loan probably is and has been used in Estonia as a mezzanine instrument in a financing deal, but only one specialist could point out only one specific case, where subordinated loan was being planned to use.

The deal involved enterprise transaction and in addition to senior lender (bank), the buyer was willing to use subordinated loan from a third party to meet the equity requirement to make the deal happen. All of the parties were involved from the beginning, however, senior lender was not willing to consider third party in the deal as subordinated loan provider who had share pledge as collateral. The bank pointed out that the deal was too small to be so complicated and that third party brings additional risk to the deal in the eyes of the bank, if any case the shares of the company should change ownership, then the bank would be facing new owner, who had no experience in the field. Therefore, the senior lender requirement was that the mezzanine should be provided by professional mezzanine lender. Unfortunately, Estonia lacks local professional mezzanine providers. Therefore, the deal did not go through in the initial formation. In the end, bank was willing to provide more loan to value and the buyer acquired more equity, so the deal could happen.

During the interview with a small local bank, it turned out that specific bank is currently providing mezzanine loans to local entrepreneurs in the form of subordinate debt. At the moment, the outstanding balance for them are two loans, while one of them is emitted to a cash-flow real estate project. The bank confirmed that they could also be willing to finance real estate development project if the company is reliable and has strong track record. One of the requirements of the bank providing the subordinated loan is that they want to receive equity like elements from the deal. These equity kicker elements could be unique in every deal.

Other interviewees also mentioned that one option of subordinated loan is also additional equity from the shareholder that is transmitted into company not in the form of equity, but loan. In Estonian legal framework, this gives simplicity to transmit the equity or profit out of SPV-s or holding company, when necessary. Withdrawing capital out of the company if it is share capital, is much more difficult and time consuming. For that reason, most of the new companies acquire their equity from the owners actually in the form of owner loan. This loan, however, must be subordinated to all other creditors, which is a requirement by senior lenders if providing additional senior loan to the company, according to the financial specialists interviewed.

Participants agreed that subordinated loan is the most straightforward mezzanine instrument that could be widely used in Estonia, however, the deals most often remain

unknown from public records, as financial advisers are not involved in these deals and majority of the companies find the investor and organize the deal themselves. However, it was also concluded that it is difficult to use subordinated debt together with senior debt in a transaction, as the willingness of senior lenders to participate in such deals is low. Much easier is to include subordinated loan after the senior lender has stepped in, if the covenants of the senior loan allow including additional capital to the company.

None of the specialists could point out the range of interest, which subordinated loan could be provided to real estate development projects. It was said that the interest rate depends very much on the borrower, lender, project and economic cycle. However, it was also said that the interest rate will probably be over 10% in the current market conditions, taking into account the subordinated nature of the loan, which involves higher risk than senior loan.

The problem of receiving subordinated debt in Estonia is more likely to be the obstacle of finding investors to provide the loan. In the environment, where the economy lacks professional mezzanine investors and financial advisers are not specialised on providing and mediating subordinated loan, one of the obstacles is to make both interested parties meet. Therefore, real estate companies might be ready to involve additional financing in the form of subordinated loan, but without well-established investor base and network, the capital involvement is extremely complicated.

The financial advisers who were interviewed, pointed out that the collaterals used in the subordinate debt deal remain the same as described in Estonian bond section. Most likely second ranking mortgage is used, if the deal is to qualify under mezzanine terms i.e. subordinate debt is additional loan to senior loan, which has acquired first ranking mortgage. Therefore, all other collaterals from starting from second ranking mortgage to name and reputation of the company, could be utilized, to provide the investor with the confidence necessary. Financial specialists who were interviewed, could point out that share pledge has been widely used in the lending processes in Estonia together with subordinate debt. Most of these deals have been not related to real estate and in the last economic downturn, some companies changed ownership in the light of difficulties that were caused by heavy lending.

3.9 Preferred equity

Mentioning the term preferred equity as mezzanine financing instrument to Estonian financial specialist did not bring too wide feedback. Most of the interviewees did not know to mention any specific case, where preferred equity elements would have been used. It was pointed out that, most of the business operations in Estonia are performed in the form of limited liability companies. Estonian Commercial Act states that limited liability company shareholders are all equal on equal terms and no benefits over other shareholders could be granted. Financial advisers stated that of course shareholders and partners in business could arrange agreements between each other, which could regulate profit sharing and management of the company, but in nature, limited liability company (*osatühing* in Estonian) is not designed for preferred equity options to be used in practise, as in case of disputes, the law does not define specific guidelines, rather it states that all shareholders are equal.

Public limited company (*aktsiaselts* in Estonian), on the other hand, has different rights on different types of shares defined by the Estonian Commercial Act. Preferred shares, allow the owner of the shares to receive pre-assigned dividend each year, which must be stated in the articles of association. If the dividends are unpaid one year, they must be capitalized and repaid the next year with interest. The law also gives preferred shareholders right to receive cash-flows and cash from asset liquidation before the other shareholders. However, preferred stockholders are still subordinate to all other creditors.

In general, it was recommended for the companies to use preferred equity options, if the company is in the form of public limited company in Estonia. From the commonly known examples of preferred equity usage, publicly listed textile and fashion manufacture company Baltika AS was mentioned, who has emitted preferred shares on the stock market. There were no other known examples in Estonia that could be mentioned by the interviewees.

Participants in the interviews claimed that on the most important effect to use preferred equity in the case of professional mezzanine investor involved in a mezzanine deal, are the potential equity kickers that could be part of the equity sharing. At the same time preferred equity allows to distribute profit without involvement in the management of the company, which is highly crucial factor for most of the Estonian business owners. However, due to the nature, that Estonian financial market does not involve local professional mezzanine investors willing to invest into real estate development projects, preferred equity has been largely unused so far in the real estate sector and according to the interviewees, it will remain in the same situation in the near future as well. Most of the mezzanine financing in Estonia today could be carried out in the form of subordinate loans or bond emissions, leaving equity kicker elements out of the options, as local investors are not asking for these kind of elements in the deal and companies are not willing to offer these themselves either. It was also mentioned, that Estonian senior lenders do not prefer to finance mezzanine deals, which involve equity elements or share pledge for the mezzanine investor, while this exposes the senior lender to the possibility that at some point the new owner of the development project might be mezzanine investor with no experience in real estate sector.

Another benefit of the use of preferred shares was seen for the companies that involve several shareholders, like the companies listed on the stock market. In this case, the additional shareholders that could be involved in the initial public offer or share emission with additional capital invested into the company add managerial obstacles to the company if the rights of the shareholders are not governed or distinguished. Therefore, preferred shares give an option to receive capital benefits before other shareholders to the investor and managerial and administrative ease to the management and initial owners of the company.

3.10 Warrants and convertible debt

Experts interviewed, confirmed that there are only a few cases where warrants and convertible features of mezzanine debt have been used in Estonian mezzanine deals. They also confirmed, that the motivation of regular Estonian private investor is usually not gain equity share in the project, as this creates another problem in the exit phase, how to liquidate the share. This might be a problem specifically in the non-real estate

investments, but in real estate it is somewhat less complicated to find a new investor or buyer for the share, as the value of the property could be easily estimated. However, it is in the interest of professional mezzanine investors to receive equity like features from the mezzanine deal that would allow to gain from the upside potential from the investment. For the borrower, warrants and convertible debt are both elements that could be used in mezzanine deals to provide investor with extra motivation to lower the interest rate by providing additional potential options for the investor to gain from the deal and all in all increase the return.

As the usage and history of local mezzanine deals has been extremely low, if not to say non-existent, the participants in the interviews could not comment the specific usage of warrants and convertible debt in Estonia. However, it was said that only professional investors ask these mezzanine elements to be a part of the deal, including local banks that are providing mezzanine loans, local Estonian private individuals are not aware enough to demand equity features in the deal. Neither are local developers in real estate sector too much willing to share the profit, therefore, developers are looking more for fixed interest debt instruments, i.e. bank loan, subordinated loan and bonds with fixed interest. Only two examples could be drawn which have used convertible debt and were brought out by one of the interviewees. Pro Kapital Grupp AS and Baltika AS have emitted convertible bonds. Both of these companies are listed on Tallinn OMX Stock Market. The conclusion by the advisers on warrants and convertible debt, was that it is more appropriate to use these elements when the company is registered as public limited company (*aktsiaselts* in Estonian) and in the case the company is listed on stock exchange or in the case where the deal involves professional mezzanine investor.

3.11 Banks as a participant in a mezzanine deal

It was clarified before, that according to Estonian financial advisers, most of the deals that could include mezzanine elements, do not occur due to unwillingness of senior lenders to participate. During the process of interviews, participants were also asked, what would make senior lenders (banks) to participate in deal that involve mezzanine financing. Some specialists, who are employed at the financial advisory sector in Estonia claimed that senior lenders agree to take part in financing, which involves mezzanine investor, if the deal value is great enough. The assumption was, that the total deal value should be around 10 M Euros, of which senior lender would provide on average 70% i.e. 7 M Euros.

Another criteria, when senior lender would agree to participate in a mezzanine deal would be if the mezzanine is structured as equity and is structured on the equity side on the balance sheet. For the borrowers this would imply to share the total profits of the project, which is not so much appreciated by the developers. It was also said, that senior lenders need to have full confirmation, that they have first ranking on the collaterals, which the borrower has provided. In real estate sector, it is undoubtedly first ranking mortgage on the property, which is the underlying asset of the business project. Whereas, in other business sectors, it has happened that senior lender has found itself on second or third ranking on receiving capital in the liquidation process of the assets.

During the interview with a local Estonian bank that has provided both senior and junior loans to real estate sector, following aspects were brought out that the bank evaluates before agreeing to finance the deal as senior lender:

- Ability to return the loan
- Willingness to return the loan
- Background of the mezzanine investor
- Deal value

It was confirmed that the bank is willing to participate when the mezzanine is structured as equity in general, although one interviewed bank claimed, that it is not important and mezzanine could also be structured as debt in the deal. However, senior lender and junior lender need to be confident that collaterals provided to them are valuable enough. Interviewed bank suggested, that they are looking for second ranking mortgages in the real estate mezzanine deals. In addition, intercreditor agreement was mentioned as very important element of the deal necessary for both senior and junior lender that would state both the rights and obligations of both lenders and the borrower in the deal. The agreement would also state in, which case the liquidation process of the property would start, thus adding additional confidence to the mezzanine lender, that they could not be left bare handed.

4. Conclusion and discussion

In the last section of the study findings of the study are discussed and overview of the research is given. It is discussed if the objectives set in the beginning of the research were achieved, also suggestions for future research will be provided.

4.1 The results of the research

The aim of this research was to identify the use of mezzanine finance in Estonia and to define real possibilities that Estonian real estate developers have to acquire additional finance in the form of mezzanine finance.

The research began with explaining the concept of debt and equity and the ways to acquire both forms of capital from the market. It was also explained different types of debt and equity and their characteristics. From this point it was easy to move to the concept of mezzanine finance, which in essence is capital that is between equity and senior loan by its characteristics. These characteristics could include subordination by the rights in occurring cash-flows and in liquidation process. One important aspect to be qualified as mezzanine finance is that both equity and senior loan need to be part of the capital structure.

Mezzanine finance could be structured in different ways, either debt or equity, depending where on the balance sheet the capital is intended to be, ending with different elements that could be added to the deal, i.e. interest rate and profit sharing rights. Mezzanine finance could be provided in different types that have different characteristics, including corporate bonds or subordinate loans that could include various equity elements like preferred equity, warrants and convertible debt. It was concluded in the interviews for this study that there are indefinite ways to structure a mezzanine deal and each transaction is tailor made depending on the needs and wishes of the borrower and lender.

It was brought out by the interviewees that a key element of successful mezzanine financing transaction could be the existence of sufficient collaterals to the mezzanine investor. Some collaterals that are used only in the US capital markets were explained, including second deed of trust. Also, other collaterals that could be used in Estonia were discussed, including first and second ranking mortgage, which are most relevant in real estate sector, but also assignment of partnership interest (share pledge) and cash flow note were brought as examples.

Literature review gave wide overview of mezzanine usage in international experience, however, the goal of the research was to understand the possibilities Estonian real estate developers have at the moment to finance development projects using mezzanine finance. It was clear after conducting the interviews, that Estonian experience in mezzanine sector is extremely low and the awareness of such type of financing possibility is very low. Low awareness causes low demand for mezzanine and as a result only a few specialists are committed to provide and advise mezzanine deals, but so far, due to low demand only a handful of deals have been conducted.

Low demand is also related to low supply, hence at the moment only one institutional investor on Estonian capital market could be identified that provides mezzanine loans. In the past there were additional investors that were seeking mezzanine investment

opportunities with equity elements, but after the financial downturn in 2008, these investment companies have left and have not returned at the moment. Local financial advisers agreed that Estonian government has a strong role to enliven local financial market, by boosting bond market with government bonds. Working bond market could help local companies to collect capital from bond market, which currently is functioning with very low volumes.

If the senior lender is willing to finance deal which involves mezzanine element, then local real estate developer is due to find willing investor, who would be ready to finance real estate development projects. According to the interviews, it is most likely to happen while using corporate bond or subordinate debt, as local investors are not asking for equity like elements in the deals. The most important feature for the borrower is credibility and strong track record. If the company has conducted successful development projects in the past and has clean debt record, the chances to acquire mezzanine debt are high.

It was confirmed in the study, that acquiring mezzanine finance for a local real estate developer is possible, most likely in the form of corporate bond or subordinate debt, but the crucial factor is the acceptance from senior lenders, who in majority are large Scandinavian banks and have very conservative view on mezzanine. This is mostly due to economic downturn experienced in the Baltics after the 2008, which even today has its consequences. It reflected from many interviews, that there would be some local real estate companies that would be willing to use mezzanine finance, but the attitude of the senior lenders currently is the obstacle to be surmounted.

All in all, the study revealed that Estonian mezzanine capital is underperforming and only a few possibilities are used compared to well-functioning capital markets in the US and UK. Nevertheless, it was pointed out that realistic possibilities for real estate developers are existent. As a result the study succeeded to point to receive realistic answers concerning the current state of Estonian mezzanine finance. The chosen method to conduct interviews with Estonian top financial specialists was the one and only method to acquire information regarding this topic as literature based information on Estonian mezzanine finance was practically non-existent. However, it should be noted that the analysis and the result on the study is very much based on the persons interviewed and their views, which might not reflect the objective truth. Therefore, the results of the study should be noted with this fact taken into consideration. The potential benefit of this study is to raise awareness in Estonia of the use and benefit of mezzanine finance among potential investors and developers. Also, to provide some specific ideas, in which form mezzanine finance could be used.

4.2 Further research

This research covers only a minor part of the knowledge of mezzanine finance use in Estonia, as it was difficult to acquire information on the deals conducted in this area. However, it came into interest of the researcher during the interviews that the interest rate of mezzanine finance is in accordance with the collaterals provided by the borrower, therefore, it seems and it was confirmed that the stronger the collateral the lower the interest rate.

Further knowledge could be obtained if fictional or real life questionnaire would be conducted among the investors where on equal debt amounts different collaterals would be provided and participants are asked to mark the interest rate they would be willing to provide the debt with different collaterals provided to the same borrower. This information could be useful to the companies to understand investor expectations before offering specific loan terms. Also, it would be useful in financial planning, if the companies would be aware of different interest rates with different collaterals.

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Appendix 1

Questions about Estonian mezzanine instruments and deals to Estonian financial specialists

General questions:

1. What kind of mezzanine instruments can you name that you personally consider being under categorization of mezzanine finance? These mezzanine finance instruments do not necessarily need to be related to real estate
2. What type of mezzanine instruments to your knowledge have been used in Estonian capital market?
3. To your knowledge, do you know if real estate sector has been subject of mezzanine financing in Estonia?
4. If any mezzanine deals have occurred in Estonia, then has the real estate type been development or cash-flow?
5. How great could be the volume of mezzanine deals in Estonian real estate projects in year 2014?

Questions regarding corporate bonds:

1. If and how much have high-yield bonds been used in recent years to finance real estate developments in Estonia?
2. What is the ratio between high-yield bonds and bonds with collateral compared by their emission volume in year 2014?
3. What could be the interest rate range for bond emission in real estate development sector?
4. What factors affect the interest rate of a bond the most and in what extension?
5. What kind of collaterals could be provided to investors listing bonds that have been emitted to finance real estate development (if first ranking mortgage on property is occupied by senior lender)?
6. How to characterise Estonian investors that are investing in bonds in Estonia?
7. Is typical Estonian bond investor:
 - a. Private individual or institution
 - b. How great is the average listing of one investor
8. Are foreign investors also investing to Estonian bond market?
9. What should change in Estonia that emitting and listing bonds would be more popular among investors and companies?

Questions about warrants and convertible debt

1. Do you know any mezzanine financing deals in Estonia where warrants have been one element of the mezzanine financing deal?
2. If yes, then what specific criteria has been used (e.g. what % of the project)?
3. To your knowledge, has convertible feature been involved in any mezzanine deals in Estonia?
4. How would a typical mezzanine deal be structured, if convertible debt is involved? When and what extension have debt been converted into equity in financing cases in Estonia so far?

Questions about preferred equity

1. To your knowledge, has preferred equity been a part of any mezzanine deals in Estonia?
2. Could the features of preferred equity be used in Estonian limited liability companies (*osajühing*), opposed to public limited liability company (*aktsiaselts*)?

Questions about subordinate debt

1. To your knowledge if and how much has subordinate debt been used a form mezzanine finance?
2. What kind of collaterals would the investor like to see in case of subordinate debt and which of those could realistically be offered to the investor?
3. How much has the subordinate debt been used in Estonian real estate development projects?
4. What could be the average interest rate for real estate development companies using subordinate debt as a form of mezzanine finance?

Questions about senior and junior lender relationship

1. What are the reasons why senior lender (bank), should accept third partner in the deal (mezzanine investor)?
2. Why banks in general are trying to avoid being part of mezzanine deals in Estonia?